Philippine Economic Outlook

MAY 2000

Inside...

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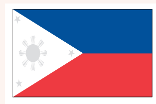
Introduction

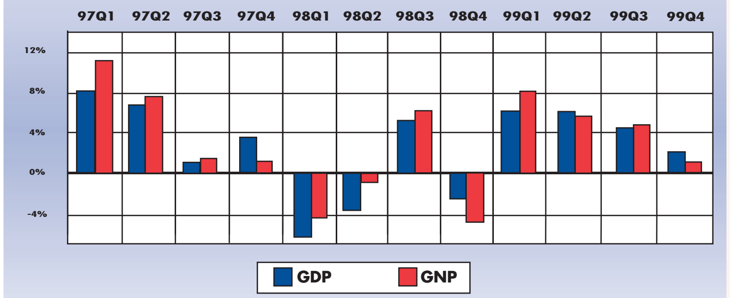


The economic fundamentals in the Philippines are improving. Based on new data, we have raised our forecast for Philippine GDP growth to 3.8% – 4.4% in 2000 (up from 3.5% - 4.0% in our January *Outlook*). Interest rates and inflation remain low, exports and manufacturing output are growing, and the government's fiscal performance appears to be improving. Significant progress has been made on legislation that will move the economy forward, such as power sector and banking reform and e-commerce legislation. In order to make the recovery sustainable, however, the government faces significant challenges, including a sometimes deafening array of background noises such as stock market scandals and perceptions of political instability. A positive economic performance for the year will, hopefully, give the Estrada administration breathing room to implement the additional reforms needed to continue current positive trends.

Output is up, with an accelerating revival of manufacturing. Agriculture, which rebounded 6.6% in 1999, will grow at a slower rate. Inflation will likely accelerate on stronger demand, but should remain within the government's 5%-6% target for the year. The banking sector is sound, but a major scandal in the Philippine Stock Exchange has left equities markets in disarray. While this has not played well in the international business press, it has had only a small effect on the real economy, as most local firms rely more on debt than equity for capital, and foreign investors in the Philippines rarely look to the stock market for capital. The BW Resources fracas may, in the end, have a serendipitous effect as the government begins to more effectively and systematically address transparency and governance problems it faces.

Despite this upbeat near-term assessment, the government must overcome many long-term challenges to ensure that current gains are sustained and expanded. Most significant is maintaining an environment conducive to continued investment. Several issues cloud the investment horizon. An aviation dispute has cut into tourist arrivals from Taiwan and imposed costs on travelers — including Filipinos working in Taiwan — who have to travel via Hong Kong. It has also impacted the electronics industry by raising costs and lengthening delivery times for components and finished products shipped between the Philippines and Taiwan. Another key issue for investors is the high cost of electricity in the Philippines (second highest in the region after Japan). The government and Congress need to pass power sector restructuring legislation and, once it is passed, ensure its prompt, effective implementation. Foreign investors are also deterred by perceptions of instability, drift, and corruption in government; ongoing efforts to reverse those perceptions must be redoubled and sustained to bear significant fruit. Poor infrastructure, including a terribly congested road network, cut into productivity. Continued trade and tariff reforms that further open Philippine markets to the global economy are needed, as are steps to remove barriers to foreign investment. Much has been done, but much remains to be done.

While increased trade and investment will accelerate growth in the Philippine economy, the government must also take steps to ensure equitable growth in the country to meet its poverty alleviation goals. Key here are steps to improve agricultural productivity and develop and expand rural infrastructure. Over half of the Philippine population depends directly and indirectly on agriculture. Efforts to expand economic opportunities in rural areas would also help to reduce pressures on overstressed urban infrastructure. Reductions in a bloated bureaucracy and improved tax administration would give the government more resources to undertake such rural development projects, both independently and with international agencies such as the Asian Development Bank. Such moves will help the administration address stark income disparities and move toward its goal of reducing poverty incidence to 20% by 2004.



QTR.-to-QTR. GDP & GNP GROWTH
Seasonally Adjusted Annualized Rates

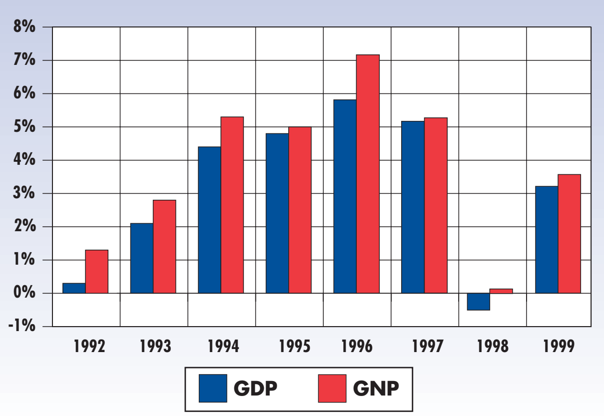
Output and Inflation

We have revised our January forecast for full-year GDP growth of 3.5-4.0% upwards to 3.8-4.4%. This puts us at the low end of public forecasts. The Asian Development Bank, in its latest Asian Economic Outlook, forecasts Philippine GDP growth at 4-5%. The IMF and most private sector forecasts have also been ratcheted upwards in recent months. We believe those forecasts are a bit on the optimistic side because private construction has been slow to recover, because government spending will be less expansive, and because agriculture remains vulnerable to vagaries of the weather.

Economic expansion in 2000 will depend on the pace of recovery of the private, non-agricultural sector as the government reverts to a more cautious spending plan and agriculture to a more normal growth pattern. Emerging signs of stronger sales combined with heavily drawn down inventories point to improved industrial sector output. Exports of electronics will continue to grow but first quarter data suggests the growth rate may be significantly lower than in 1998 and 1999. And the government's fiscal performance for the first quarter has improved. On the negative side, business confidence remains weak — far weaker than is justified by economic fundamentals. Politics — the perception of drift and mismanagement — weigh heavily on consumer and business confidence. Sustained growth beyond the short-term will depend on boosting business confidence, continuing with market-based reforms, and sustainable fiscal improvement.

Fourth quarter GDP and GNP expanded at their strongest year-on-year rates since the 1997 onset of the Asian crisis. Real GDP was up 4.6% and GNP was up 4.8% over the fourth quarter of 1998. That performance partly reflected growth from an especially weak fourth quarter 1998 base. The service sector contributed 44% of overall GDP growth, followed by agriculture (33%) and industry (23%). The industrial sector — up year-on-year for a second consecutive quarter — mustered 3.1% growth as manufacturing output growth accelerated. Manufacturing production increased over comparable 1999 levels for a third straight quarter. Even construction, the sector hardest hit by the Asian crisis, saw modest 0.5% year-on-year growth thanks to government infrastructure spending. This came after seven consecutive quarters of year-on-year declines. Exports contributed significantly to the fourth quarter's demand expansion, followed by personal consumption and government spending. 1999's last quarter also saw some restocking of inventories after two successive quarters of net drawdowns.

REAL YEAR-TO-YEAR GDP & GNP GROWTH



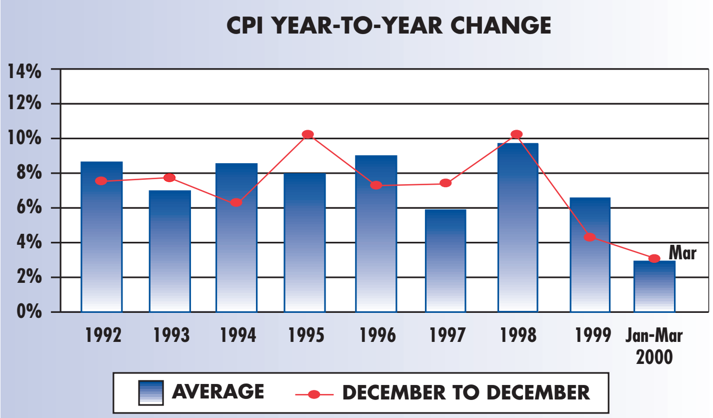
Full-year 1999 GDP and GNP grew 3.2% and 3.6%, respectively — both at the upper end of government targets (2.6-3.2% for GDP and 3.0-3.7% for GNP). Exports and public sector spending (including government construction expenditures) spurred the accelerated full-year GDP expansion on the demand side. Investment in durable equipment contracted 5.5% in 1999 after an 18.1% decline recorded in 1998. On the output side, real 1999 GDP grew at a faster pace largely because of the agricultural sector's rebound from 1998's record 6.6% drought-induced losses. Full-year 1999 agricultural output increased 6.6% over 1998, surpassing the 3.0-3.5% growth the government had projected. Without this performance, overall 1999 GDP would have grown at the lower end of the government's targeted range. The industrial sector's 0.5% expansion was an improvement over 1998's 1.9% decline but lagged government expectations of 1.4-2.0% growth for the 1999 full-year (mainly because of the drop in construction activity). At end-1999, both agricultural and industrial sector output had yet to fully recover to 1997 real levels.

Year-on-year consumer price inflation averaged 3% during the first quarter of the year. The normalization of food prices from an unusually high first quarter 1999 base (resulting from late-year 1998 typhoon-induced food supply bottlenecks) tempered the effect of increased world crude oil costs on domestic fuel and utility rates. Going forward, however, we expect year-on-year inflation to accelerate on stronger domestic demand, utility rate adjustments, and the follow-through effects of 1999 increases in the minimum wage. Prices during the second half will also be coming off a relatively low second semester 1999 base, translating to higher twelve-month rates. The government recently cut its inflation forecast a full percentage point to 5-6% because first quarter price increases were lower than expected. The government's new inflation target is probably reasonable absent major external shocks and weather disturbances.

Labor and Employment

The latest quarterly labor force survey (January 2000) estimated the Philippine unemployment rate at 9.3%, somewhat higher than in January 1999 (9%). The labor force expanded by 2.2% (680,000 persons), outpacing the 1.9% (527,000) growth in jobs. An improved underemployment situation, however, partly compensated for the shortfall in new employment opportunities. The underemployment rate contracted by almost a percentage point to 21.2% and the number of underemployed declined by 2.5% (equivalent to 152,000 persons). The industrial sector, which laid off workers in 1998 and 1999, continued to post job losses due to continuing difficulties in the construction business. However, the government is relying on emerging improvements in manufacturing employment and stronger economic growth to generate more jobs as the year progresses.

While the overall employment situation may be improving, large disparities between the rural and urban sectors continue to pose important policy challenges. In the January 2000 labor survey, the rural unemployment rate (12.1%) far exceeded that in urban areas (6.7%).



* Base Year 1994

Underemployment was also far more severe in rural areas (62.5%) than in urban centers (37.5%). Rural residents make up the bulk (70%) of the Philippine population living below government-estimated poverty thresholds. Agriculture, which absorbs about 40% of the employed, accounts for a relatively small (20%) share of Philippine GDP. The sector's low productivity has hampered its ability to efficiently supply industries with needed inputs. At the same time, low rural incomes limit the otherwise higher growth potential that could be spurred by a stronger consumer base.

Financial Markets

The Bangko Sentral ng Pilipinas (BSP, the central bank) maintained a neutral interest rate policy during the first four months of 2000 despite successive U.S. interest rate increases and downward pressure on the peso. Following an uneventful Y2K rollover, the monetary authority reverted to an 11% overnight lending rate (after having temporarily increased that rate to 12% in December to prevent arbitrage of a special Y2K credit facility). At the end of April, the Bangko Sentral increased overnight rates 25 basis points ahead of strong expectations that U.S. rates would be increased more aggressively in coming months. BSP Governor Buenaventura signalled that further increases will follow if U.S. rates continue to rise. This is the first rate increase since Buenaventura assumed office in July 1999. U.S. Federal fund rates have risen a cumulative 125 basis points over the same ten-month period, raising concerns that narrowing differentials between foreign and domestic yields could trigger an exodus of portfolio capital and destabilize the foreign exchange market.

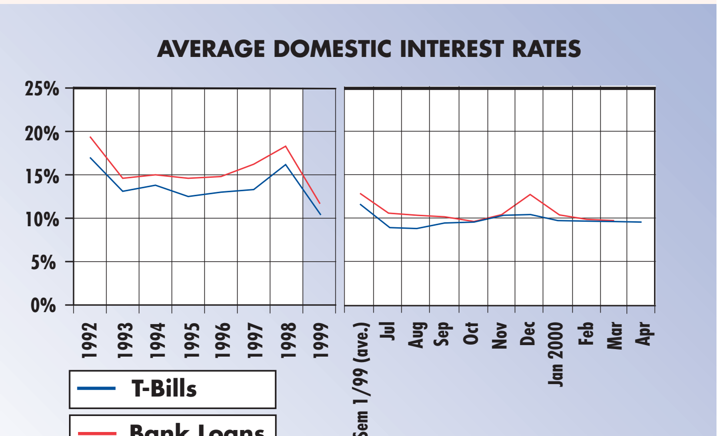
The specter of U.S. rate increases and fiscal uncertainties (arising in part from the delayed passage of the 2000 budget) generally pushed up bid rates for the government's Treasury instruments. The Bureau of Treasury fended off significant hikes in actual, published rates by regularly making only "partial awards" at the government's weekly auctions whenever bid rates rose by more than the Treasury deemed "reasonable." Rates began easing again in late March as the national government reported that its fiscal program was on track and a $1.6 billion global bond issue boosted government coffers. Lower rates also reflected the limited alternatives available to banks with excess liquidity. Benchmark 91-day T-bill rates averaged 8.669% during April's last auction, compared with 8.898% at the beginning of the year. However, 91-day T-bill rates were increasingly sticky in recent auctions and there were emerging pressures on the longer-term tenors — a strong indication that rates may be bottoming out. Adjustments in Bangko Sentral open market rates are also likely to influence the direction of rates on government debt.

There are emerging signs of a modest revival in bank lending. Commercial bank loans were up year-on-year from November 1999 through the first two months of 2000, after successive year-on-year declines since December 1998. Total loan portfolio ended 1999 up 2.6% year-on-year, and loans as of February 2000 were up 0.9% over 1999's comparable period. Bankers expect loan growth to accelerate this year, but nowhere near the almost 30% average yearly rate at which commercial bank credits had expanded from 1991 to 1997. Bankers generally expect loans to expand by no more than 10% as banks continue to clean up their portfolio of bad debts and foreclosed assets. The measured ratio of commercial banks' non-performing loans (NPLs) stood at about 13.8% of total loans as of February 2000, compared with 12.3% in December 1999 and less than 4% before the Asian crisis. The peso value of their "non-performing assets" — the sum of NPLs and foreclosed assets — rose 5.4% between the end of 1999 and February 2000. Restructured loans accounted for 5.1% of total bank loans, more than 5.5 times the pre-Asian crisis ratio. Banks continue to add to loan loss reserves; they increased from 5.7% to 6.2% of total commercial bank credits between December 1999 and February 2000.

The Bangko Sentral continues to pursue a "bigger is better" strategy to build a more resilient and regionally competitive banking sector. A phased increase in minimum capitalization requirements (announced in March 1998 and continuing through end-2000) and regulatory incentives for mergers have put pressure on smaller banks to seek partners. The past eighteen months has seen six mergers involving nine commercial banks, a thrift bank and two rural banks. These include mergers between Philippine commercial banking industry giants Equitable Bank and PCI Bank, and between Bank of the Philippine Islands and Far East Bank. As of end-April, another fifteen proposed mergers or acquisitions were awaiting Bangko Sentral approval.

The government has also shown greater resolve in dealing with weak banking institutions. The country's smaller thrift and rural banks (which comprise only 10% of total banking system assets) were more severely affected by the effects of the economic crisis. The authorities closed 77 rural and thrift banks from 1997 through the end of 1999, but only one commercial bank (in 1998, the victim of excessive lending to related parties). These closed banks constitute less than one-half of one percent of the total resources of the Philippine banking system. So far in 2000, a further 11 thrift and rural banks have been closed.

Further consolidation in the banking sector is a certainty. About fifteen commercial banks and some 190 thrift and rural banks failed to meet end-1999 minimum capital requirements. A few have reportedly applied to downgrade their licenses, while the rest are subject to



*As recorded by Bangko Sentral, lending rate refers to ratio of actual interest income to outstanding loans, rather than to banks' quoted rates for new loans. T-Bill rate is weighted average for all maturities.

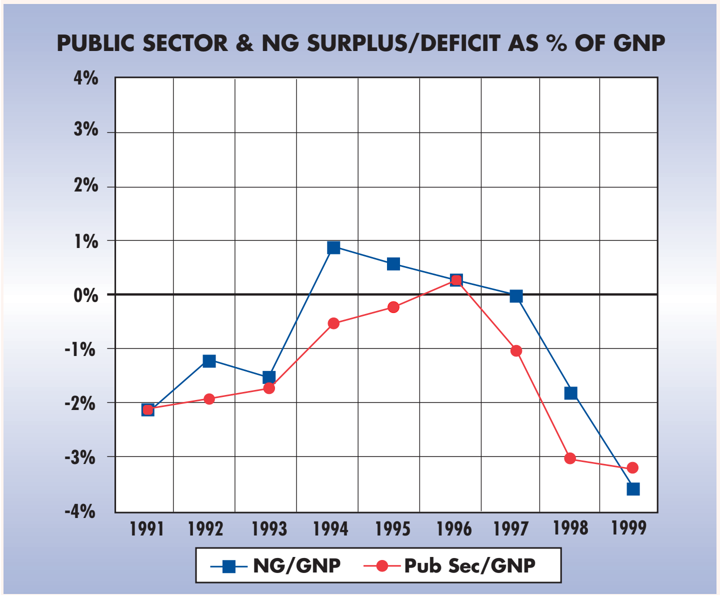
a "prompt corrective action program" introduced by the Bangko Sentral in late 1998. Minimum capital requirements will increase again at the end of 2000.

On April 25, 2000, Urban Bank declared a bank holiday, and was closed by the BSP the following day. The Philippine Deposit Insurance Corporation (PDIC) immediately took physical possession of Urban Bank's branches and began paying out insured deposits. Urban Bank had applied to downgrade its commercial bank license to a thrift bank license because it could not meet the new minimum capital requirements. This — and rumors allegedly spread via "text messaging" — led to heavy withdrawals which the bank was unable to service. Urban Bank's collapse led to heavy withdrawals at several other smaller commercial banks, but prompt action by the BSP to provide liquidity seems to have eased depositor concerns as of this writing.

The BSP's prompt response to Urban Bank's self-declared bank holiday and to the threat of a wider banking panic deserves considerable praise. BSP and the Bankers Association of the Philippines have also initiated steps to ensure that any future liquidity problems can be dealt with. It is in marked contrast to the Bangko Sentral's months of dithering over Orient Bank in 1998-1999. BSP only formally closed Orient Bank eighteen months after the bank closed its doors — apparently a world record for a "bank holiday."

The Philippine stock market was Asia's worst performer in 1999 and has fallen sharply in the first four months of 2000. Regional uncertainties, U.S. interest rate increases, and a choppy U.S. equities market have all affected Asian markets. Their impact in the Philippines combined with investor uncertainties over political and economic policy risks. The Philippine Stock Price Index (Phisix) dipped 25.4% in the first four months of 2000 to an eighteen-month low. Foreign investors have largely abandoned the market. From January to April 2000, net foreign capital outflows from the Philippine equities market amounted to P19.7 billion (approximately $482 million).

A major stock market scandal involving a relatively obscure, publicly listed gaming firm (BW Resources) added to investor worries. BW Resources' share price rose from P4 to P107 before collapsing again to P7-10. A report by the Philippine Stock Exchange's (PSE) Compliance and Surveillance Group (CSG) implicated a number of brokers and individuals (including individuals closely linked to President Estrada) of insider trading and generating false trading activity to push up the BW Resources share price. Allegations of political interference and in-fighting within the Securities and Exchange Commission added to the negative publicity. The case climaxed with the resignation en masse on March 7 of the PSE's CSG (which slammed the exchange for being an "old boys club" determined to protect, rather than police, its ranks); and the subsequent suspension of the PSE's self-regulatory organization (SRO) status.



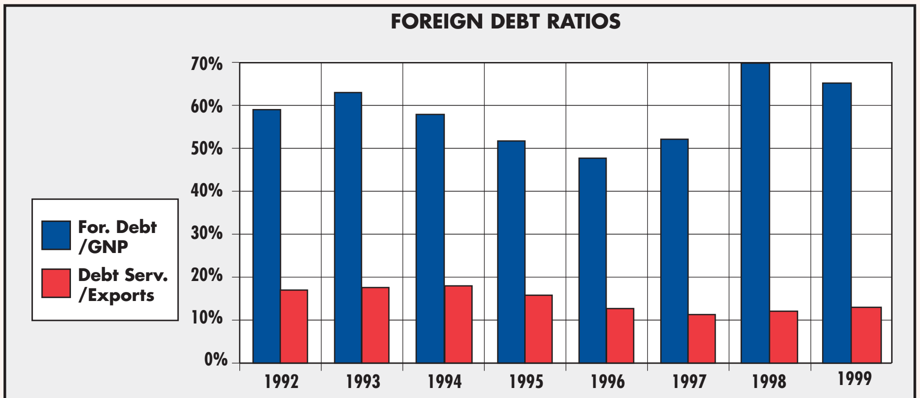
Fiscal Performance

The government's medium-term fiscal goal calls for gradually declining deficits, beginning in 2000, and a balanced consolidated public sector budget in 2003. A "pump-priming" spending plan and persistently weak revenues resulted in a P111.7 billion deficit in 1999 (3.6% of GNP, the highest deficit-to-GNP ratio since 1987). The deficit of the consolidated public sector — which includes the Bangko Sentral, government-controlled corporations and government-administered agencies — was P102.8 billion (3.3% of GNP), close to the government's target. The stronger-than-expected income generated by government-administered social security agencies and deferred capital outlays by government-controlled firms partially made up for the national government's wider-than-programmed fiscal gap.

The immediate goal for 2000 is to reduce the national government deficit to P62.5 billion (1.8% of GNP), and that of the consolidated public sector to P82.2 billion (2.4% of GNP). The government targets revenues to grow by 18% this year. If achieved, this would be a major improvement in the 4% revenue growth seen in 1999. About a fourth of additional revenues are expected to come from a P22 billion privatization program. We think that target is too ambitious in current circumstances. Even if it is successful, privatization will not provide a sustainable revenue stream. The 2000 budget also calls for a tight spending plan. On February 16, following heated and protracted congressional debates, President Estrada signed into law a P629 billion budget for the 2000 calendar year. This was P22 billion less than the executive branch had proposed. Budgeted expenditures are only 4.7% higher in nominal terms than in 1999 — a decline in real terms. The congressionally-mandated cuts reflected skepticism at the government's revenue forecasts and determination to achieve the deficit target. Congress imposed P7 billion in outright cuts and P15 billion in "contingent cuts" (including P10 billion from allotments to local government units), money which can be released only if revenues exceed targets.

Tax effort slid to 13.8% of GNP in 1999, the lowest level in nine years. Tax collection agencies argue that 1999 economic growth was spurred by agriculture, a lightly taxed sector. Nevertheless, weak tax collection has been a long-standing problem. One study estimated that about half of value-added and personal income taxes, and about 40% of corporate income taxes, escape collection. The government and the legislature are currently investigating a multi-billion peso tax credit scam. Major tax cases have languished in the courts. Inefficient tax collection has increased public resistance to higher taxes and to new tax measures to narrow the deficit. Strong public opposition forced the government to phase in over several years a proposed increase in motor vehicle users' taxes, and also delayed implementation of higher government fees and charges. In spite of these difficulties, the Bureau of Internal Revenue reported that first quarter tax collections had exceeded targets, and that estimates of April revenues (when the BIR collects the bulk of personal income taxes) were also ahead of projections. This may represent better tax efforts; it also reflects more realistic collection targets.

The structure of government expenditures makes it extremely difficult to efficiently address the country's urgent infrastructure, health and education needs. Personnel costs alone constitute about a third of national government disbursements. Add debt servicing costs and mandated transfers to local government units and the national gov-



	1992	1993	1994	1995	1996	1997	1998	1999
FOREIGN DEBT/GNP (%)	59.6	63.8	58.9	51.7	48.6	53.1	70.0	65.0*
DEBT SERVICE/ EXPORTS (%)	17	17.1	17.4	15.8	12.7	11.6	11.7	13.0

*Estimated from partial 1999 data.

ernment has only 30% in "discretionary" spending at its disposal. The administration's proposed 2000 budget included P2 billion for government "re-engineering" but the plan appears to have fizzled out for now. Several administrations have tried — but failed — to rationalize a bloated bureaucracy.

Fiscal weaknesses have perennially pushed the government to a difficult crossroad: to rein in spending at the expense of economic growth; or to expand the deficit at the cost of high inflation and interest rates. Preliminary estimates indicate that the national government's first quarter fiscal performance bettered programmed levels, pointing to the positive revenue impact of a broader-based economic recovery. The government can continue to muddle through yet another budget year, but structurally weak public finances pose a serious threat to the Philippines' long-term growth potential and its ability to compete in a more fiercely competitive world economic environment.

Foreign Debt and Debt Service

The government's financing program continues to rely heavily on foreign capital as part of an effort to keep pressure off domestic interest rates. However, the Philippines plans to borrow less this year, partly because it envisions a much-reduced fiscal gap. During the first four months of 2000, actual inflows included $1.6 billion from a national government global bond issue and $500 million from a syndicated loan to the Bangko Sentral. The government had planned to raise another $700 million from the international bond market between April and early May. It decided to postpone the offering, tentatively to mid-year 2000, because of the recent volatility in U.S. stock and bond markets. The government was also likely concerned over the international reaction to the stock market scandal and the risk premiums lenders might demand. The Philippines continues to find a ready market for its foreign currency debt, but the spread on Philippine bonds over U.S. Treasuries has widened to about 400 basis points — double the spread on similar Thai debt.

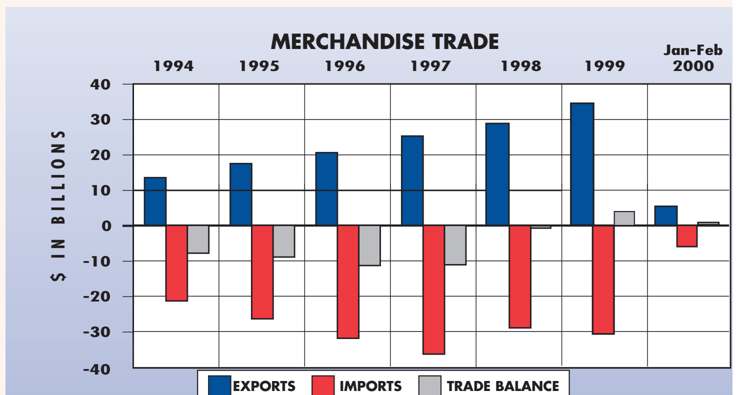
The Philippines' three-year $1.4 billion standby arrangement with the International Monetary Fund (IMF) should have concluded in March 2000. The Philippines failed to meet the current arrangement's targets, mainly because of 1999's large deficit. The Philippines and the IMF agreed to extend the program to June and it may be extended further to December. The extension would give the government more time to improve its fiscal performance and complete committed reforms (such as the full and transparent privatization of the Philippine National Bank and legislation to restructure the energy sector). The Philippines can draw a further $645 million under the arrangement. The government has indicated it may negotiate for a follow-on arrangement when the current IMF program expires.

The Philippines also continues to receive assistance from other bilateral and multilateral creditors. However, the country's development assistance donors have repeatedly complained of the government's weak implementation record — an issue of increasing importance as competition for foreign capital intensifies. In February, for example, the World Bank announced that it had approved $250 million in loans for the Philippines, but was canceling a similar amount for seven projects that were never fully implemented (including one for tax computerization). More loans face cancellation due to implementation backlogs.

The Philippines' recorded foreign debt was $51.2 billion as of September 1999, up 7% ($3.4 billion) from the end of 1998. The bias for medium- and long-term maturities (87% of the country's foreign debt stock) and the relatively small (25%) share of the private, non-bank sector were advantages in coping with the Asian crisis. Foreign debt servicing — which peaked at close to 40% of merchandise and service export receipts during the early 1980s — is no longer a severe problem despite nominal increases in the country's foreign debt stock. Debt service payments in 1999 equaled 13% of goods and services exports. Although manageable, 1999's debt service ratio was the Philippines' highest in four years. Looking forward, heavy reliance on foreign borrowings is not a viable long-term strategy — a lesson painfully demonstrated by the debt crisis of the 1980s and Asia's recent financial crisis. Strong exports have helped keep the Philippines' debt service burden manageable despite the rising level of outstanding foreign credits; conversely, however, unexpected reversals in export performance would impose a heavier foreign debt service load.

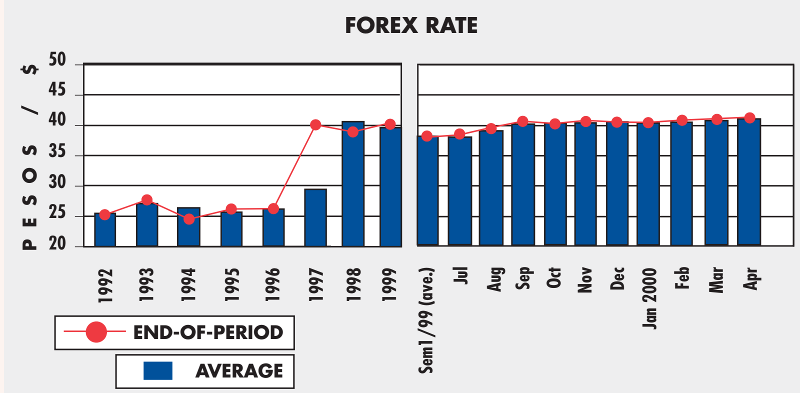
Merchandise Trade and Balance of Payments

The Philippines recorded in 1999 its first merchandise trade surplus ($4.3 billion) in over two decades on the back of the region's best export growth. Full-year merchandise export receipts were up 18.8% over 1998. Exports of electronics and peripherals, up 23.5%, con-



	1994	1995	1996	1997	1998	1999	Jan-Feb 2000
EXPORTS	13.483	17.447	20.543	25.228	29.496	35.032	5.619
IMPORTS	-21.333	-26.391	-31.885	-36.355	-29.524	-30.726	-5.134
TRADE SURP/DEFICIT	-7.850	-8.944	-11.342	-11.127	-0.028	4.306	0.485

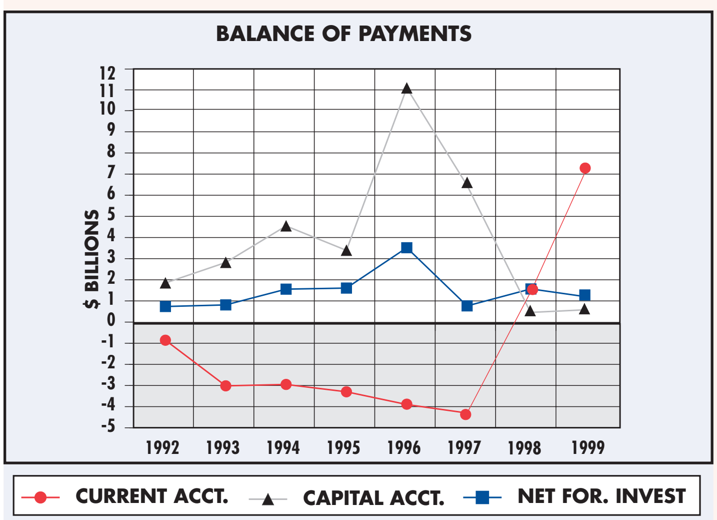
tributed nearly three-fourths of the overall expansion in 1999 export receipts. Imports increased only 4.1% ($1.2 billion) on stronger demand during the second half of the year. Imports had declined 18.8% ($6.8 billion) in 1998. About a third of 1999's import growth came from a $400 million increase in the country's oil import bill due to higher crude oil prices. The current account surplus widened to a record $7.2 billion (9% of GNP). The capital account posted a modest $590 million surplus, not much higher than 1998's. Net foreign investment fell by $500 million and the short-term capital account recorded substantially bigger net repayments, partially offsetting larger inflows of medium- and long-term loans. The Philippine balance of payments (BOP) nevertheless ended 1999 with a surplus of $3.8 billion, nearly triple the 1998 level.



*End-of-period data refers to average foreign exchange rate on last trading day of indicated period.

Estimates for the first quarter of 2000 showed export receipts up 9.6% over the first quarter of 1999. This is a sharp deceleration from the fast export growth seen in 1998 and 1999. It may reflect only a slowdown in electronic exports after exceptionally high late-year 1999 levels (spurred by Y2K-related supply disruption fears), but its continuation for a third month raises the possibility that export growth will settle to more "normal" levels. January-February imports increased 10.3% over 1999's comparable period and are expected to pick-up further as the economy expands. The two-month trade surplus was $485 million, somewhat smaller than 1999's comparable $494 million figure.

Preliminary estimates — computed from the change in BSP net international reserves — placed the country's overall BOP position at a surplus of $926 million as of March 2000. The comparable 1999 surplus was $1.9 billion. Although we expect both the merchandise trade and current accounts to remain in the black for the full year, recovering imports will likely mean smaller surpluses than in 1999. The government's current financing program also calls for lower foreign borrowing in light of a lower deficit goal, while the flow of foreign investments will depend on improving investor confidence. We anticipate a substantially narrower BOP surplus for the full year.



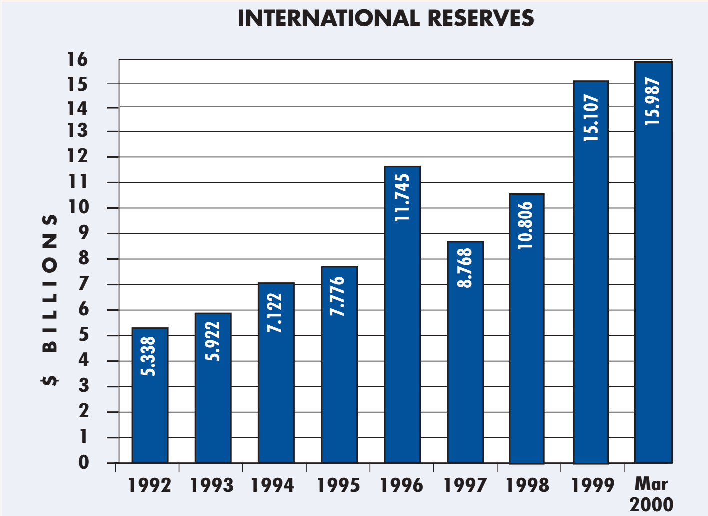
Foreign Exchange Rate and International Reserves

The peso weakened further from the P40.25/$ rate at which it closed 1999, influenced by regional currency movements and regional and domestic news and rumors. Somewhat stronger foreign exchange demand to fund imports and higher world oil prices, as well as withdrawals of portfolio capital, also weighed down the peso. By late March, the peso was consistently trading below the P41/$ mark. The local currency received a further jolt from Wall Street's "bloodbath" in April and speculation over further U.S. rate adjustments. At one point (April 26), the peso sank to its lowest level (P41.40/$) in eighteen months. The peso ended April at 41.28/$, 2.6% weaker than its 1999 close. The Bangko Sentral — equipped with a comfortable international reserve buffer — has refrained from trying to defend the local currency. In January, the Bangko Sentral moved to temper foreign exchange volatility by requiring a minimum 90-day holding period for foreign investments registered as peso time deposits (otherwise, the investor will not be allowed to purchase foreign exchange from the banking system for repatriation or remittance purposes).

The Bangko Sentral ended 1999 with gross international reserves (GIR) of $15.1 billion, exceeding its year-end 199 target of $14.7 billion. That buffer increased further to nearly $16 billion by the end of 2000's first quarter, boosted by proceeds from the government's $1.6 billion global bond float. The end-March GIR cushion equaled 4.6 months worth of goods and services imports and was more than double the Philippines' short-term foreign debt. The Bangko Sentral is targeting a further GIR build-up to $17.1 billion by year-end, in order to maintain a more than four-month import cover. The Bangko Sentral also estimated that banks' foreign currency deposit units (FCDUs) had about $15 billion in deposits as of December 1999, about 89% of which represented deposits of Philippine residents.

Legislative Developments

The Philippine Congress has shown a greater sense of purpose in recent months, and has made significant progress in advancing badly needed economic reforms. In January, for example, the Congress passed a bill opening retail trade to foreign investment, which President Estrada signed into law in early March. While the new law retains significant restrictions, it reflects a major step forward. In the weeks just prior to the Easter recess, the Congress pushed out a flurry of economic legislation. An omnibus bill restructuring the energy sector and privatizing the National Power Corporation was passed by the House (Senate action is still pending). Both houses ratified a bicameral conference committee report that rewrites the country's 50-year old General Banking Act, allowing more effective oversight and greater foreign participation in the sector. Both houses passed differing versions of a Revised Securities Act which should, once the differences are reconciled in a bicameral conference, allow reforms to prevent a repeat of the BW Resources scandal and build up investor confidence in capital markets. A Road Users Tax will



generate new revenues to expand and maintain an overburdened transportation network. The bicameral report on the tax was approved by the Senate; approval is pending in the House. And the Senate passed E-Commerce legislation that will help bring the Philippines into this field bursting with opportunity; a similar bill is pending in the House.

Challenges and Prospects

The Philippine economy's performance so far in 2000 clearly shows that the country has shaken off the worst effects of the Asian economic crisis and is on an expansionary path. Last year's growth in the agricultural sector is spreading to the industrial and services sectors as consumption demand supplants the reduced stimulus from government spending. We remain a bit more cautious about this year's forecast than other observers because we have concerns about whether export growth can be sustained at recent levels and because agriculture remains vulnerable to weather-related setbacks.

The challenge for the government is to strengthen the foundations of the economy so that it can sustain growth above 5% — probably the minimum needed to make significant inroads into poverty. The solution is to adopt the kind of open pro-market policies that have done so much to improve the lives of other people in Asia during the past four decades. The Philippines needs to seize the initiative in moving forward to promote investment in job-creating industries — from both foreign and domestic investors.

The agricultural sector — supporting more than half of the population directly and indirectly — is in urgent need of reform. Agrarian reform has not improved the condition of poor Filipino farmers. The Philippines' agricultural policies keep prices high to maintain rural incomes. But rural Filipinos remain poor while high food prices — the highest in Southeast Asia — keep low-wage workers in poverty. Sugar prices are nearly at U.S. levels, yet the industry is unprofitable and sugar workers are among the poorest of the poor. The high price of corn and the cost of transporting it inter-island make chicken and hog producers uncompetitive so they have to be protected — again at the expense of low-wage Filipinos.

Major investment is needed in the country's infrastructure. The transportation network is particularly inadequate; it increases costs and denies economic opportunities to people in outlying regions. It also forces industries to huddle in and around Manila, drawing more and more people to an overcrowded metropolis.

The third great need is education. A growing population and inadequate resources have already led to deterioration in the public education system. One study says that 30% of students fail to complete grade six. The greatest attraction for foreign investment is the availability of reasonably well-educated English-speaking workers. Sustained high levels of investment in high-skill jobs could drain what now seems like an inexhaustible supply of well-trained workers with adequate language skills.

Underlying all three of these issues is the problem of public finance. Weak public finances constrain the economy's ability to grow by limiting the money available to address needs like infrastructure and education. The government could do a lot to streamline its operations and improve the efficiency with which it spends money. Nearly three-quarters of government spending is on personnel costs, debt service and transfers to local government. Ultimately the government needs more money. That means better tax collection and new taxes. There is only so much that can be done in the way of improved efficiency. Better schools and infrastructure require more investment.

PROJECTIONS FOR 1999: SELECTED INDICATORS

	1998 Actual	1999 Actual	2000 Forecast[a]
GDP Growth (Year-on-year, %)	(0.5)	2.7-3.1	3.8-4.4
GNP Growth (Year-on-year, %)	0.1	3.2-3.6	4.3-4.9
Average Year-on-Year Inflation (1994=100, in %)	9.7	6.6	5.0-6.0
Average 91-day T-bill rate (%)	15.3	10.20	9.7-10.5
Average Forex Rate (Pesos/US$)	40.89	39.04	41.00-42.00
Exports ($ Billions)	29.50	35.0	39.9
Growth (Year-on-year, %)	16.9	18.8	14.0
Imports ($ Billions)	29.52	30.7	35.6
Growth (Year-on-year, %)	(18.8)	4.1	16.0
Trade Balance ($ Billions)	(0.03)	4.3	4.3

[a]Embassy projections as of April 2000

Sources (1998 and 1999 data): National Economic and Development Authority, Bangko Sentral ng Pilipinas

PHILIPPINES: KEY ECONOMIC INDICATORS

(In Million USD, unless otherwise noted)

	1998	1999	2000 *p/*	
Domestic Economy				
Population (millions)	73.5	75.2	76.9	
Population growth (%)	2.32	2.32	2.32	
GDP (current) *a/*	65,111	76,466	-	
GNP (current) *a/*	68,215	80,275	-	
Per Capita GDP, current dollars *a/*	886	1,017	-	
Real GDP (% change, yr.-on-yr.)	(0.5)	3.2	-	
Real GNP (% change, yr.-on-yr.)	0.1	3.6	-	
Consumer Price Index (ave. % change, yr.-on-yr. 1994=100	9.7	6.6	3.0	Jan-Mar
Production, Employment, Fiscal Accounts				
Labor force (millions) *b/*	31.1	32.1	31.8	Jan
Unemployment rate (%) *b/*	10.1%	9.6	9.3	Jan
Industrial prod. (1985=100), % change yr.-on-yr.	(1.9)	0.5	-	
Nat'l gov't budget surplus (deficit) *a/*	(1,222)	(2,856)	(549)	Jan-Mar
as % of GNP	(1.8)	(3.6)	-	
Consolidated public sector surplus (deficit) *a/*	(2,034)	(2,630)	-	
as % of GNP	(3.0)	(3.3)	-	
Interest Rates (%)				
Average T-bill rate *h/*	16.30	11.02	9.75	Jan-Apr
Average bank loan rate *c/*	18.39	11.75	10.03	Jan-Mar
Balance of Payments				
Exports (FOB)	29,496	35,032	5,619	Jan-Feb
Growth (%, yr.-on-yr.)	16.9	18.8	9.1	Jan-Feb
Imports (FOB)	29,524	30,726	5,134	Jan-Feb
Growth (%, yr.-on-yr.)	(18.8)	4.1	10.3	Jan-Feb
Trade Balance	(28)	4,306	485	Jan-Feb
Current Account balance	1,546	7,188	-	
as % of GNP	2.3	9.0	-	
BOP surplus/(deficit)	1,359	3,839	926	Jan-Mar
Net foreign investment flows *d/*	1,672	1,218	-	
Foreign Debt, as of end of period *e/*	47,817	51,172	-	
Debt service paid	5,095	6,247	-	
Debt service (% of exports of goods and services)	11.7	13.0	-	
BSP International Reserves	10,806	15,107	15,987	March
Exchange Rate (pesos/$)				
Average exchange rate	40.89	39.09	40.78	Jan-Apr
Closing exchange rate *f/*	39.14	40.30	41.28	Apr
Foreign Direct Investment (BSP registrations) *g/*				
Total (cumulative, since 1973)	9,305	11,199	11,221	Jan
U.S. (cumulative, since 1973)	2,722	2,806	2,810	Jan
U.S. share (%)	29.2	25.1	25.0	Jan
U.S.-Philippine Trade (Phil. Data)				
Philippine exports to U.S., FOB	10,098	10,444	1,680	Jan-Feb
Growth (%, yr.-on-yr.)	14.6	3.4	11.7	Jan-Feb
Philippine imports from U.S., FOB	6,562	6,365	1,047	Jan-Feb
Growth (%, yr.-on-yr.)	(7.9)	(3.0)	4.9	Jan-Feb
Philippine trade balance with U.S.	3,536	4,079	63.3	Jan-Feb
U.S. share of Philippine imports (%)	22.3	20.7	20.4	Jan-Feb

a/ originally peso values, converted to USD; *b/* average of quarterly surveys (Jan/Apr/Jul/Oct); *c/* computed as the ratio of banks' actual interest income to outstanding loans (rather than quoted rates for a given period); *d/* direct and portfolio; *e/* since 1994, excludes "net due to" accounts of foreign commercial banks; *f/* average on last trading day of indicated period; *g/* principally exercised to enable forex purchase from the banking system for capital repatriation and profit remittances; *h/* weighted average for all maturities; *p/* preliminary

Sources: National Economic and Development Authority; Department of Finance; Bangko Sentral ng Pilipinas